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July 31, 1998

Via Facsimile: (303) 231-3385
& Overnight Mail

Mr. David S. Guzy, Chief
Rules & Procedures Staff
Royalty Management Program
Minerals Management Service
Building 85, Denver Federal Center
Denver, Colorado 80225

Re: Establishing Oil Value for Royalty Due on Federal Leases
(63 FR 38355, July 16, 1998)

Dear Mr. Guzy:

Marathon appreciates the opportunity to submit the enclosed comments on MMS' recently published further supplementary proposed rule for establishing oil value for royalty due on federal leases.

Notwithstanding Marathon's request that MMS modify its proposal as set forth in these comments, the implementation of a federal royalty-in-kind program remains the best long-term solution to the complexities and uncertainties that exist in any valuation process.

If you have any questions, please contact me.

Sincerely,

Dow L Campbell

Dow L. Campbell

Enclosure

[04038]

cc: The Office of Information and Regulatory Affairs
Office of Management and Budget
Attention: Desk Officer for the Department of the Interior
725 17th Street, NW
Washington, D.C. 20503

Marathon Oil Company
Comments on MMS' Further Supplementary Proposed Rule Establishing Oil Value for Royalty Due on Federal Leases
63 FR 38355 - July 16, 1998

INTRODUCTION

In the **Federal Register** of July 16, 1998 (63 FR 38355), the Minerals Management Service ("MMS") proposed further changes to its proposed rule amending the regulations governing the royalty valuation of crude oil produced from federal leases. MMS' original proposal was published in the **Federal Register** on January 24, 1997 (62 FR 3742); a supplementary notice was published in the **Federal Register** on July 3, 1997 (62 FR 36030); the comment period was reopened by notice published in the **Federal Register** on September 22, 1997 (62 FR 49460); and a supplementary notice was published in the **Federal Register** on February 6, 1998 (63 FR 6113). Marathon Oil Company ("Marathon") has committed substantial resources to provide constructive comments at each stage of this process and welcomes the opportunity to comment on the latest proposed regulations.

DEFINITION OF AFFILIATE

Although Marathon supports MMS' recent return to the definition of affiliate as exists in the current regulations, more must be done. The regulations fail to provide any standards or procedures for rebutting the presumption of control in the 10 to 50 percent ownership range. According to MMS, it has never approved a company in the 10 to 50 percent ownership range as being non-affiliated. Marathon has appealed a value determination based on this type of fact situation, and MMS has been inflexible in permitting Marathon to prove that ownership of an interest between 10 and 50 percent does not constitute control. (See docket number MMS-96-0386-O&G). In light of the combination of the absence of stated standards or procedures for overcoming the rebuttable presumption and MMS' track record on this issue, MMS' concession to retain the current definition appears to be nothing more than a hollow attempt to sidestep the real issue here - what level of ownership constitutes a controlling interest in an affiliate. Accordingly, Marathon supports retaining the current definition of affiliate with the addition of procedures setting forth the means to rebut the assumption of control.

TRACING OF EXCHANGED LEASE PRODUCTION

Marathon commends MMS for attempting to respond to industry concerns regarding the February 6, 1998 proposal to require federal lessees to trace all exchanged production downstream of the lease. However, MMS' proposed "first-exchange" rule, in its current form, is not an acceptable alternative in that it still does not fully address the problems inherent in any MMS-imposed tracing requirement.

The current version of MMS' "first-exchange" rule would do little to relieve the federal lessee of undue administrative burdens. First, this rule would still require a lessee to trace lease production subject to a single exchange agreement through to the destination of the initial exchange. Furthermore, in order to identify the proper methodology to employ for royalty valuation purposes (i.e., gross proceeds or index pricing), the lessee would next have to trace all crude oil volumes for which it has title at the exchange point to determine whether all or a portion of the volumes were sold at arm's length. In the event that one or more sales transactions did occur at that location, the lessee would then have to prorate a portion of the total sales volume back to every lease whose production had been relocated (either by pipeline or by exchange agreement) to the same location. Finally, once this entire analysis had been completed, the lessee would be required by this rule to value a portion of lease production using a gross proceeds methodology and the remaining portion using an index price methodology. Marathon fails to see how this alternative "first exchange" rule would in any way significantly reduce the administrative burden inherent in MMS' February 6, 1998 proposal.

To illustrate the problem caused by MMS' proposed "first exchange" rule, MMS should consider the situations illustrated by the two attached charts. In the example illustrated by Chart No. 1, entitled "Tracing Situation: MMS Theory", the MMS' latest tracing proposal would be relatively straight-forward to apply for royalty valuation purposes. Clearly, the final disposition of the offshore lessee's exchanged production can be traced to an arm's-length sale at an onshore market center. In this instance, the federal lessee would only be required by the "first exchange" rule to analyze two transactions: (1) the initial exchange of 55,000 barrels at Empire, Louisiana and (2) the subsequent arm's-length sale of those 55,000 barrels at Cushing, Oklahoma.

However, most of the exchange transactions which occur in the crude oil marketplace today are far more complex than this particular example. As a result, the effort required of the federal lessee to apply MMS' current tracing proposal to actual exchange situations is a much more burdensome task than that envisioned by MMS. To demonstrate this point, Chart No. 2, entitled "Tracing Situation: Marketplace Reality," illustrates a typical situation involving an exchange of lease production pursuant to a single exchange agreement. Under MMS' proposed "first exchange" rule, the federal lessee of this particular offshore lease would first have to analyze the initial exchange of 78,000 barrels at Empire, Louisiana, of which only a portion is actually attributable to the lessee's offshore lease. The lessee would then be required to analyze 37 subsequent transactions and several pipeline shipments covering the disposition of over 4,000,000 barrels at Cushing, Oklahoma in order to determine how much, if any, was sold at arm's length. It is beyond question unreasonable to require a lessee to perform this burdensome analysis on an ongoing basis for each of its federal leases.

Marathon urges MMS to adopt the use of lease-based benchmarks as a fair and reasonable method for valuing lease production exchanged at or near the lease. A lease-based benchmark system, using arm's-length transactions at the lease, would eliminate the extreme burden of tracing downstream transactions. If MMS insists on including a tracing requirement in its final valuation rule, the requirement should be written in a way so as to apply only to the type of situation illustrated by Chart No. 1; that is, tracing of lease production would be required when the arm's-length sale involves only the further disposition of the aggregated volumes covered by the initial exchange agreement.

DEEPWATER GATHERING VS. TRANSPORTATION

MMS specifically asks for comments regarding the definition of "gathering" as it applies to deepwater developments. MMS is correct when it states that in the case of deepwater developments, especially those involving subsea completions with no platform, bulk or unseparated production is often moved many miles before it first surfaces and is treated on a platform. This situation was not an issue when the current regulations were promulgated in 1988, but technological advances since that time have made it a concern which must be addressed in any proposed oil valuation rule. Recent technological advances in subsea completions have made it possible for oil companies to produce oil and gas from reserves which would not otherwise be economically feasible. As a result, the federal government's royalties have increased substantially.

The current definitions of "gathering" and "transportation" address the common onshore and offshore production scenarios where production is metered and treated in the field or on a local platform. However, deepwater developments and subsea completions are entirely different. In the case of subsea completions, the production can travel for miles before ever reaching a platform. Such costs should be treated as transportation, not gathering.

Marathon recommends that gathering be defined as any movement of production to an accumulation point on the lease premises or an adjacent lease. Transportation is any movement of production off the lease premises or an adjacent lease.

Also, when calculating the transportation allowance for an unregulated pipeline, flowline, or facility, the lessee should be allowed to apply for, and the Secretary allowed to grant, a higher rate of return for pipelines in more than 200 meters of water. A higher rate of return should be allowed in order to

recognize and compensate lessees for the additional risk in the fabrication, installation, operation, and maintenance of deepwater pipelines.

BENCHMARKS

Marathon would like to reiterate the viability of a lease-based benchmark system. Arm's-length transactions involving the sale or purchase of like-quality crude in the field or area are the best indicators of fair market value at the lease. Marathon fully supports the use of the following prioritized benchmarks for valuing royalty crude oil not disposed of at arm's-length:

1) A lessee's outright arm's-length sales of like-quality crude in the field or area (including sales under tendering programs),
2) A lessee's, or its affiliate's, arm's-length purchases from producers at the lease or in the field or area,
3) Outright sales at arm's-length by third parties (if available),
4) Prices published by MMS reflecting the prices MMS obtained for its crude oil taken in-kind (if available), and
5) An appropriate netback methodology which allows for all adjustments necessary to arrive at the value of production at the lease.

Under the first two benchmarks, a lessee should be required to sell or purchase a volume equal to a minimum of 20% of its production in the field or area. The typical onshore royalty rate is 12-1/2%, and a requirement to sell or purchase 20% of a lessee's field or area production is more than sufficient to allay MMS' concerns that lessees will "game" the system.

The benchmark system proposed by MMS in February 1998 would be applicable only to the Rocky Mountain Region, but such a system should be used in all producing regions, not just the Rockies. Crude oil is regularly bought and sold at or near the lease throughout the United States. The market dynamics which make benchmarks based on arm's-length sales feasible in the Rocky Mountain Region also make them feasible in all other regions. Assuming, for the sake of argument, that MMS' assumption is true and that there are not any arm's-length transactions, the lessee would simply use the last benchmark, which is a netback calculation.

LACK OF MMS RESPONSE TO INDUSTRY COMMENTS

MMS' lack of response to the valid concerns raised in industry comments throughout this rulemaking process has been frustrating to lessees. As it did in the preamble to its February 6, 1998 supplementary proposed rule, MMS states in this latest proposal that it intends to respond to industry concerns only after MMS has decided on the framework for its final rule. However, this seems to be an inappropriate way to deal with the numerous and complex issues involved in a rulemaking process as important as oil valuation, and it makes it all the more difficult to clear up MMS' misapprehensions. Marathon is concerned MMS will reach conclusions and adopt a final rule based on erroneous conclusions. Prior to the issuance of a final rule, MMS should publicly address critical issues such as:

- Lack of fairness and certainty to the federal lessee which may result from MMS' proposals
- Existence of markets at or near the lease
- Duty to market lessee production remote from the lease at no cost to the federal lessor
- Limitations of a NYMEX-based methodology
- Problems associated with MMS' proposed Form MMS-4415

In order to craft a reasonable, fair, and proper rule, it is imperative that MMS publicly address these and other critical issues prior to the issuance of any final oil valuation rule so that affected persons can participate meaningfully in the rulemaking process.

RESPONSE TO MMS' COMMENTS
REGARDING INDUSTRY'S RECOMMENDED IMPROVEMENTS
TO MMS OIL VALUATION PROPOSED REGULATIONS
DISCUSSED AT THE JULY 22, 1998 SENATE MEETING

The following comments are offered in response to MMS' responses to the recommended improvements to the proposed rule made by industry representatives during the July 22 Senate meeting. Our comments follow the same order used by MMS.

Non-Arm's-Length Contracts

Tendering

Marathon disagrees with the assertions made by MMS concerning the legitimacy of values derived through a tendering program.

MMS claims that a tendering program would create "an artificial market". This is simply not the case. Regardless of whether a lessee chooses to retain its share of lease production for it own use, this choice does not diminish the fact that there is an active and competitive market at the lease. However, if a lessee were to elect to institute a tendering program in locations outside of the Rocky Mountain Area, the resulting price would be anything but "artificial." To the contrary, a price resulting from the interaction of competitive market forces at the lease is the purest measure of fair market value. In denying this fact, MMS is in effect disregarding the basic tenet of the free market system; that is, the forces of market supply and market demand, if left alone, will interact to establish a fair market price.

Marathon also disagrees MMS' excessive requirements for an acceptable tendering program and it discussion of the related administrative burden. Marathon could support 20% of the total federal and non-federal production in a particular field or area as representing a significant volume for benchmarking purposes. Also, MMS offers no basis for its claim that valuing royalties at a price derived through a tendering program is more administratively burdensome than MMS' proposed index methodology. A market price which is actually negotiated by a lessee and an unaffiliated third party is readily available to the lessee and can be easily provided to MMS for audit verification. Furthermore, spot prices are more administratively burdensome because they must be subjected to numerous adjustments in order to approximate market value at the lease.

Comparable Arm's-Length Transactions

MMS' response to industry's proposal to use comparable arm's-length transactions as a non-arm's-length benchmark includes a claim that its audits have turned up little evidence of arm's-length transactions. Marathon disagrees with this assertion. In our comments submitted in response to MMS' January 24, 1997 proposed oil valuation rule, Marathon cited a study conducted by Professor Joseph P. Kalt of the Harvard University Kennedy School of Government. As a result of his study, Professor Kalt was able to compile a database representing over 850,000 arm's-length transactions at lease markets during 1990-1996 in just New Mexico, Texas, and Oklahoma. Furthermore, numerous tendering programs have been implemented in the last couple of years, and MMS' audits may not have extended into this time period yet. In addition, the vast majority of Marathon's transactions are currently at arm's-length. MMS' statement regarding its audit findings is likely based mostly on market activity from time periods as far back as the 1980's. If MMS has evidence which supports its claim that very little Federal oil is currently sold at arm's-length, it should present this data and offer industry an opportunity to respond.

Duty to Market

Marathon has reviewed MMS' meeting notes from the July 9 and July 22 Senate meetings with the Department of the Interior and industry executives. For the record, Marathon wishes to address the

duty to market issue and reiterate Marathon's position. Marathon has long maintained that if a duty to market exists, it ends at the lease line. Mr. V.G. Beghini clearly offered that position in the July 9 meeting. Marathon firmly believes it has no obligation to bear all the costs and risks of marketing MMS' royalty share of production downstream of the lease. If MMS wants to share in the benefits of the downstream market, it must also share the costs and risks of marketing downstream of the lease.

Transportation

Tariffs

The reasonable, commercial value of transportation, including tariffs, should be used to determine transportation allowances. It is unfair for a federal lessee who has invested in a pipeline to be forced to pay higher royalty simply because it owns an interest in a transportation asset. In effect, MMS wants lessees to subsidize the transportation of royalty oil.

Marathon is strongly opposed to MMS attempting to develop a procedure to set pipeline transportation rates. There are certain limited instances in which it is appropriate for MMS to develop procedures for calculating transportation allowances (for example, proprietary lines without third party shipments), but under no circumstances would it be appropriate for MMS to determine actual transportation rates.

Non-binding Guidance

In response to industry concerns regarding the non-binding value determinations offered under 30 CFR 206.108, MMS suggests that binding determinations be requested from the Department's Assistant Secretary. However, unless MMS can assure the federal lessee that the Assistant Secretary is willing and able to respond to valuation determination requests in a timely manner, this option still provides the lessee with little certainty. Also, if MMS intends to continue issuing non-binding determinations, any royalty underpayments resulting from a lessee's reliance on such determinations should be free from interest and penalty assessments.

CONCLUSION

The adoption of a benchmark system in all producing regions of the United States is a workable method of determining the royalty value of crude oil not sold at arm's-length. A netback approach should be used only when a contemporaneous value at the lease cannot be determined through a lease-based benchmark. However, no valuation policy will totally eliminate valuation disputes. Therefore, Marathon supports a comprehensive royalty-in-kind program as the most viable alternative to resolving the issue of federal royalty oil valuation. Royalty-in-kind offers the best long-term solution to satisfying the federal lessee's royalty obligation while assuring that the federal government receives fair market value for its royalty oil. Marathon urges MMS to work with industry and Congress to develop and implement a comprehensive royalty-in-kind program.

TRACING SITUATION: MMS THEORY

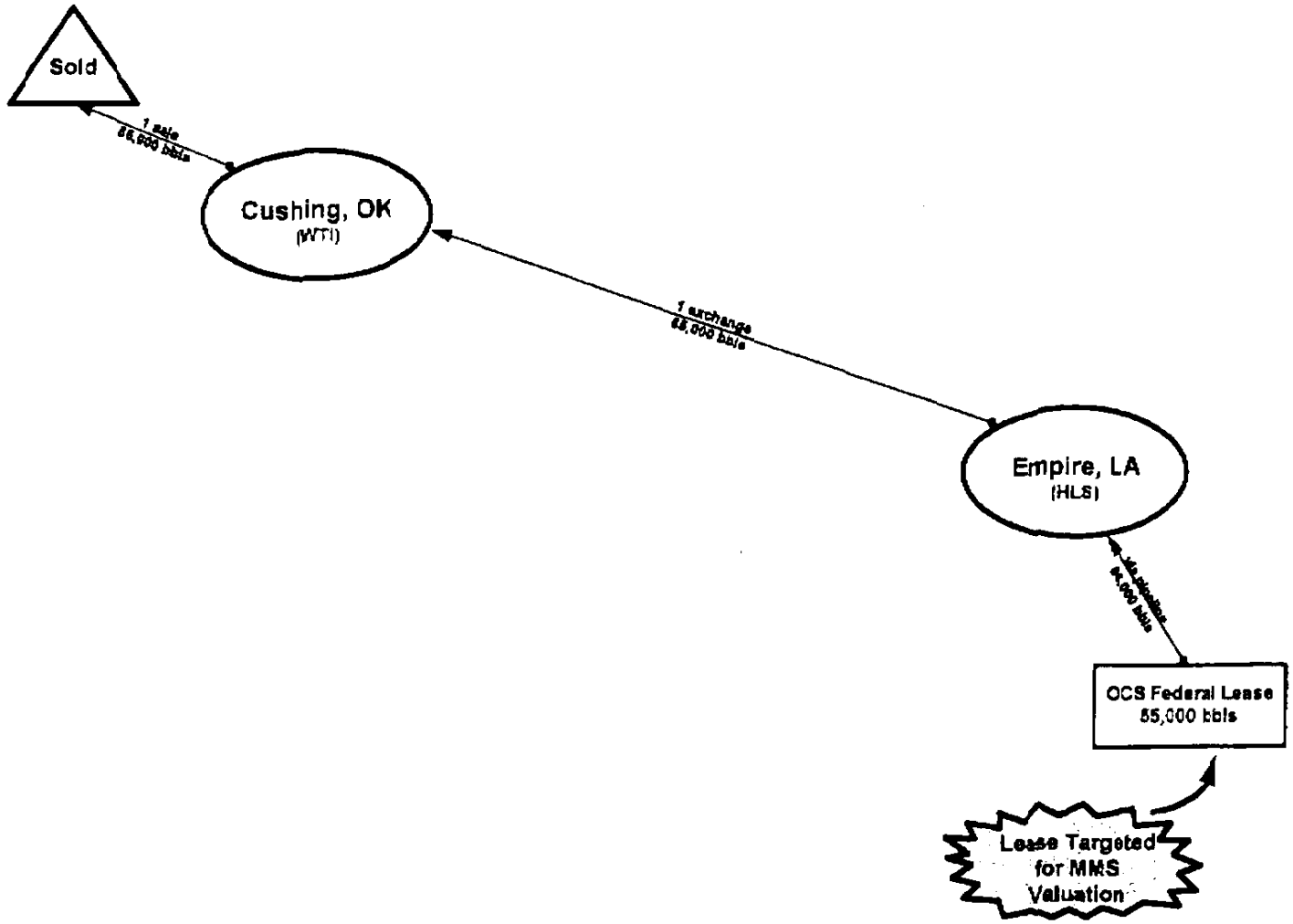
CHART NO. 1

RECAP

Volume of Targeted Federal Lease ..... 55,000 bbls

Number of Transactions Requiring Analysis 2

Total Volume Dispositions Requiring Analysis ..... 110,000 bbls



TRACING SITUATION: MARKETPLACE REALITY

CHART NO. 2

RECAP

Volume of Targeted Federal Lease ..... 55,000 bbls

Number of Transactions Requiring Analysis..... 38

Total Volume Dispositions Requiring Analysis ..... 4,314,000 bbls